

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission)	
On Its Own Motion,)	
)	
v.)	
)	
The Peoples Gas Light and)	01-0707
Coke Company)	
)	
Reconciliation of revenues)	
collected under gas)	
adjustment charges with actual)	
costs prudently incurred.)	

ADDITIONAL DIRECT TESTIMONY
OF
DAVID WEAR

- 1 Q. Please state your name and business address.
- 2 A. David Wear. 150 N. Michigan Avenue, Chicago, Illinois 60601.
- 3 Q. Are you the same David Wear who previously testified in this proceeding?
- 4 A. Yes, I am.
- 5 Q. In your testimony you refer to documents that have been marked for
- 6 identification as Respondent's Exhibits 2, 3, 4, 5, 6, 7 and 8. Were these exhibits
- 7 prepared by you or under your supervision and direction?
- 8 A. Yes, they were.
- 9 Q. Why are you submitting additional direct testimony in this proceeding?
- 10 A. Subsequent to the submission of my direct testimony in January, The
- 11 Peoples Gas Light and Coke Company ("Peoples Gas" or "Respondent")

received substantial discovery from the Commission Staff and parties. In particular, Peoples Gas received extensive questions from Staff about two topics, namely its Gas Purchase and Agency Agreement ("GPAA") with Enron North America Corporation ("ENA") and off-system transactions, with emphasis on a transaction with Enron MW, LLC ("EMW") under which Peoples Gas sold a call option service to EMW. Respondent and Staff agreed that it would be beneficial for Respondent to address these issues in more detail through additional direct testimony that would become part of the record. No party objected to this approach, and the Administrative Law Judge agreed to revise the schedule to accommodate additional direct testimony.

Accordingly, I will first describe the GPAA, explain why Peoples Gas entered into this agreement, describe the process that led to that decision and show why the gas costs incurred under the GPAA were prudent. Second, I will discuss off-system transactions. Mr. de Lara, in his direct testimony, discusses the EMW transaction. Ms. Grace, in her additional direct testimony, will discuss how Respondent will handle a refund adjustment that is associated with an error related to the EMW transaction.

Gas Purchase and Agency Agreement

1. Negotiation of the GPAA

Q. Please briefly describe the GPAA.

A. On page 4 of my direct testimony in this proceeding, I described the GPAA with ENA in the context of Respondent's overall supply portfolio. It is a five-year gas supply contract (October 1, 1999 – October 31, 2004). Respondent and

35 ENA signed the GPAA on September 16, 1999. The GPAA provides for the
36 citygate purchase of a significant quantity, but not all, of Respondent's annual
37 gas requirements. To facilitate the citygate service, Respondent released to
38 ENA, per the Federal Energy Regulatory Commission's ("FERC") rules, some of
39 its firm transportation capacity. The GPAA does not provide for the release of
40 any purchased storage capacity, and Respondent continues to operate its
41 Manlove storage field. The GPAA also provides a firm right for Respondent to
42 move gas away from its citygate, by a sale to ENA, when operational conditions
43 limit Respondent's ability to accept deliveries.

44 Q. Is the GPAA a departure from Respondent's prior gas purchasing
45 practices?

46 A. No, although, as I discuss below, the process that led to the GPAA
47 differed from Respondent's prior practices. Prior to the pipelines' implementation
48 of FERC Order No. 636 in late 1993, which removed pipelines serving
49 Respondent from the merchant function, Respondent purchased most of its gas
50 supply under bundled citygate supply services offered by pipelines. Beginning
51 with the 1993-1994 winter, Respondent has contracted with producers and
52 marketers to secure a sufficient quantity of firm gas supply to meet its customers'
53 requirements, including filling its storage capacity. These contracts have been
54 the subject of individual negotiations with suppliers, and pricing has generally
55 been tied to market-based, published indices. Some of the contracts were
56 "baseload" agreements under which Respondent was obligated to take 100% of
57 a specified contract quantity each day, and some were "swing" agreements

58 under which Respondent could choose the amount of supply it purchased each
59 day. Swing contracts could include some take requirements or they could
60 include other requirements that governed the nomination of service. Prior to
61 entering into the ENA agreement in September 1999, Respondent's firm gas
62 supply contracts had terms ranging from as short as four months to as long as
63 five years. The GPAA is very much like a combination of these contracts. Aside
64 from the process that led to its execution, the main difference is that it is a single
65 contract for a large portion of Respondent's annual requirements. Previously,
66 Respondent tended to enter into smaller contracts for the different services with a
67 larger number of different suppliers.

68 Q. How much supply did Respondent purchase from ENA during the
69 reconciliation period?

70 A. During the reconciliation period, the second year of service under the
71 GPAA, Respondent purchased xxx of its supply from ENA under the GPAA. This
72 is comparable to the xxx purchased during fiscal 2000, which was the first year of
73 service under the GPAA.

74 Q. Did Respondent conduct a "request for proposal" ("RFP") process as part
75 of its negotiation of the GPAA?

76 A. No, the GPAA was not conducive to an RFP process, which is best suited
77 to a simple contract for the short-term purchase and sale of a relatively small
78 quantity of gas. Even RFPs for such a straightforward service can produce offers
79 with special terms and conditions that make it difficult to compare bids.

80 However, several producer/marketers were invited to participate in the
81 process that led to the GPAA. The GPAA was the result of a lengthy process
82 that was precipitated by Respondent's October 1998 filing to implement a fixed
83 gas charge. Shortly after that filing, in December 1998, Respondent solicited
84 nine marketers to participate in a "request for qualification" ("RFQ") process. As
85 part of the RFQ process, Respondent examined the ability of marketers to
86 structure a full-requirements, fixed-price, gas supply proposal, and also
87 determined their competency and level of available resources to function as
88 asset manager for Respondent's supply portfolio if Respondent implemented
89 such a proposal. In the spring of 1999, Respondent selected ENA over the other
90 participants due to the fact that ENA demonstrated superior deal structuring
91 ability, trading skills and logistics support. ENA also possessed excellent assets,
92 credit ratings, and a strong record of providing reliable supplies. While events of
93 the past year have irreparably damaged Enron Corporation's reputation, during
94 the 1998-1999 time frame when Respondent was evaluating marketers and then
95 negotiating the GPAA, ENA was unquestionably one of the preeminent gas
96 marketers in the nation. Likewise, ENA was a reliable supplier throughout the
97 reconciliation period.

98 Q. The process you described was related to a fixed gas charge proposal,
99 but Respondent did not implement a fixed gas charge. How did the RFQ process
100 affect decisions subsequent to the fixed gas charge proceeding?

101 A. Although Respondent did not implement a fixed gas charge, that process
102 provided the opportunity to re-examine its traditional method of supply

103 acquisition, which coupled field-purchased supplies with firm pipeline
104 transportation. From this re-examination, Respondent concluded that there
105 existed a strong likelihood that basis at Respondent's field-purchase locations
106 would be negatively affected by the proposed incremental pipeline capacity to the
107 Chicago area. In particular, Northern Border Pipeline Company and Alliance
108 Pipeline had major projects planned for Chicago, and, in fact, these two pipelines
109 increased capacity to the Chicago area by nearly 2.0 Bcf per day. This, in turn,
110 would erode the value of Respondent's firm transportation assets, resulting in
111 relatively higher delivered costs for gas supplies connected with field purchases
112 versus those at the citygate. When firm transportation is devalued, Respondent
113 would also expect a loss of demand credits that are earned through the
114 optimization of the firm transportation through off-system transactions.

115 In June 1999, Respondent received an unfavorable order in its fixed gas
116 charge proceeding and determined it was not feasible to implement the fixed gas
117 charge in that order. Absent a fixed gas charge, Respondent concluded that a
118 full requirements contract, including outside management of storage services,
119 was not the path it wanted to take. However, Respondent determined that the
120 ENA proposal for a substantial gas supply agreement would remove basis risk by
121 ensuring index-based market pricing for gas supply and guaranteeing demand
122 credits for the term of the GPAA. Respondent did not expect that a portfolio of
123 shorter term, smaller contracts could accomplish that result.

124 Q. You referred to concerns about "basis" as a major factor in the process
125 that led to the GPAA. What do you mean by the term "basis"?

126 A. Strictly speaking, basis means the difference between the NYMEX futures
127 contract at Henry Hub in Louisiana and the cash price at other market points. In
128 the context of this testimony, I use basis to describe the difference in gas prices
129 at a location in the field area and gas prices at the Chicago citygate. For
130 example, if gas at the Houston Ship Channel is priced at \$3.00 and gas at the
131 Chicago citygate for the same time period is priced at \$3.15, the "basis" is \$0.15.
132 The basis changes from day-to-day and within the day, and it can even be
133 negative. The differential represents the value that the market is placing on the
134 pipeline transportation required to move the gas from Ship Channel to Chicago.
135 Gas purchases at the citygate have some value for transportation embedded in
136 the price. While I used Houston Ship Channel as an example, data showed
137 shrinking basis projections for all major producing regions.

138 Pipeline transportation is generally contracted for by local distribution
139 companies like Peoples Gas under long term (one year or more) firm
140 agreements, and the price is within a cost-based range in the pipeline's tariff.
141 While the basis is a proxy for the value of pipeline transportation, the price that
142 shippers pay for transportation typically does not change from day-to-day. The
143 changing value of transportation is manifested in changing gas prices.

144 Information available to Respondent at the time it was negotiating the
145 GPAA (see Exhibit 2), such as analyses by the Cambridge Energy Research
146 Associates ("CERA") reviewing trends and projections for the 1996-2001 period,
147 showed a likelihood that basis would be declining. Respondent's review of
148 projections for the period of the GPAA (1999-2004) showed a similar trend. A

149 declining Chicago basis is the same as a decline in the value of transportation.
150 Hence, a citygate gas purchase agreement that included some assurances about
151 recovery of the value of Respondent's underlying transportation assets would be
152 a way to counter declining basis.

153 Q. What does Exhibit 2 show about basis?

154 A. Exhibit 2 shows CERA data and projections for the 1996-2001 period for
155 major North American producing and consuming regions. Exhibit 2 also shows
156 Respondent's data for the period during which the GPAA would be in effect.
157 Respondent's information is based on confidential basis quotes that it received
158 from a variety of parties that regularly conduct such business. To help illustrate
159 what is shown in Exhibit 2, Respondent has charted the basis differentials
160 between the supply basins that would commonly feed Respondent's pipeline
161 transportation assets and Chicago. This was done for both the CERA data and
162 Respondent's data, and the results are shown in Exhibit 3. In each instance, the
163 basis differentials show a downward trend, both for the four years prior to the
164 start of the GPAA, as well as for the projected five-year term of the agreement.

165 Q. How would declining basis be expected to affect Respondent's ability to
166 generate revenues, which would offset gas costs, from off-system transactions?

167 A. To the extent that basis differentials had been greater than the variable
168 costs of transporting gas from the field to the citygate, Respondent had been
169 able to optimize these transportation assets on days when they were not needed
170 for meeting system requirements. Declining basis differentials year after year
171 directly translate into a loss of optimization dollars. When one looks at the

172 various supply basins in aggregate, the projected decline in basis differentials is
173 slightly greater than \$0.01 per MMBtu per year. This value is obtained by
174 determining the average slope of the lines plotted on the charts in Exhibit 3,
175 which use Respondent's data projected out over the term of the GPAA. On a
176 sales volume of 40,000,000 MMBtu, (a volume that represents approximately all
177 off-system sales volume for fiscal 1999, which is the year prior to implementation
178 of the GPAA) the annual decline in optimization credits attributable just to the
179 decline in value of Respondent's pipeline transportation can be estimated at
180 \$400,000 per year. In addition, as basis differentials shrink, there is an increase
181 in the likelihood that the variable cost of transportation exceeds the basis
182 differentials, making optimization impossible. This is especially true during non-
183 winter months. The charts in Exhibit 3 show that the projected basis differentials
184 are lowest in the April through October periods when transportation assets are
185 more readily available for optimization. Therefore, not only might one expect a
186 decline in the value of the optimization transactions when they occur, but also
187 that Respondent would be presented with fewer opportunities to enter into such
188 transactions, further reducing gas charge credits.

189 Q. You stated that the GPAA resulted from a lengthy negotiation process.
190 Please describe the process.

191 A. Prior to the Commission's June 1999 fixed gas charge order, *i.e.*, during
192 the phase of negotiations that Respondent was contemplating a fixed gas
193 charge, the process involved an exhaustive review by ENA and Respondent of
194 Respondent's purchased and owned gas supply and capacity assets and how

195 Respondent used those assets to meet its customers' requirements on a daily,
196 seasonal and annual basis. Subsequent to the fixed gas charge proceeding,
197 attention shifted to assessing how the concerns about market trends, particularly
198 expected declining basis, could be addressed in a gas supply agreement.

199 The negotiations spread over several months, beginning in the spring of
200 1999 and culminating with the execution of the GPAA in September 1999.
201 During that time, the scope of the agreement narrowed from a full requirements
202 contract to a large gas supply contract under which Respondent would continue
203 to manage the assets it uses to balance its system and purchase a significant
204 amount of supply from other producers and marketers.

205 As I described in my direct testimony, the Executive Vice President, Gas
206 Supply (Mr. Morrow) oversaw the negotiation of gas supply agreements, and he
207 reported to the President and Chief Operating Officer (Mr. Patrick) on such
208 matters. Given the importance of the RFQ process and the later negotiations
209 with ENA on both the agreement associated with the fixed gas charge and the
210 GPAA, Mr. Morrow was involved on a daily basis in the negotiations. He
211 participated in many negotiating sessions and was updated at least daily on other
212 developments in the negotiations. Mr. Patrick was regularly updated on the
213 progress of the negotiations and important terms and conditions of the GPAA.

214 Q. What did Respondent hope to achieve in the GPAA?

215 A. Peoples Gas' desired outcome from the negotiations with ENA was the
216 execution of a firm gas supply contract in which the volume and pricing terms
217 met several criteria. First, the contract would have market-based commodity

pricing with no reservation or demand charges. Second, it would have flexible pricing options. Third, it would preserve the value of Respondent's transportation capacity even in the face of shrinking basis projections. Fourth, it would provide a level of flexibility that would assist Respondent in meeting normal, warmer than normal, and colder than normal weather conditions. Fifth, it would be a reasonable proxy for the aggregate gas supply contracts that had been commonly held by Respondent in prior years. As I explain in detail below, the GPAA satisfied each of those objectives.

2. GPAA Terms and Conditions

a. Quantity and Pricing Terms

Q. You stated that one criterion that Respondent expected the GPAA to meet was to provide market-based commodity pricing with no demand or reservation charges. How did the GPAA meet that objective?

A. To understand the pricing under the GPAA and how it met Respondent's negotiating objectives, the quantity terms first need to be understood.

Q. Under the GPAA, how was the quantity of gas that Respondent purchased determined?

A. The GPAA included three categories of quantity terms and conditions. First, there was a baseload quantity in effect for each month. The baseload quantity changed during the term of the GPAA, and it was an amount that ENA was contractually obligated to deliver each day and Respondent would purchase this quantity. Second, there was a "summer incremental quantity" ("SIQ"). The SIQ was an amount within a range that ENA would elect to deliver during the

summer period (defined as April through November in the GPAA) and Respondent would purchase this quantity. Finally there was a category called the "daily incremental quantity" ("DIQ"). This was the increment above the sum of any baseload and SIQ quantities and up to the total capacity that Respondent released to ENA. For example, if Respondent released 350,000 MMBtu of capacity to ENA and the baseload plus SIQ for a month was 250,000 MMBtu, the DIQ available for nomination would be 100,000 MMBtu. Respondent could nominate any portion, including zero, of the DIQ on any day.

Q. What was the purpose of the baseload quantity and how was it determined?

A. The baseload quantities in the GPAA are the result of the negotiation process during which all the terms of the structured contract were agreed to. The baseload quantities reflect similar baseload purchases by Respondent in years prior to the GPAA. As one would expect, the baseload quantities change from month-to-month and are related to changes in demand. Exhibit 4 depicts this relationship between the GPAA baseload quantity and customer requirements.

Q. What are important factors in determining an appropriate quantity of gas to contract for on a baseload basis?

A. Given the unpredictability of factors that affect Respondent's baseload requirements, selecting a baseload quantity is a difficult task. Respondent has a very weather sensitive load, as shown in Exhibit 4. Moreover, deliveries by end user transportation customers significantly affect Respondent's baseload needs. Finally, to the extent that customer usage varies from forecast usage, baseload

requirements are affected. By definition, a baseload quantity is constant for a one-month or longer period, yet requirements can vary greatly from day to day. In sum, selecting a baseload quantity that is optimal for each day is impossible.

Q. Please describe Exhibit 4 in more detail.

A. Exhibit 4 shows the daily baseload quantity in the GPAA for each month of the reconciliation period along with the expected minimum, average, and maximum daily sendout requirements for the same period assuming normal weather. The difference between the baseload quantity and the various sendout requirements would consist of a combination of transportation customer deliveries, any storage withdrawals, and any other purchases. The GPAA baseload quantity is always less than the minimum daily sendout requirements, under normal weather. This would tend to minimize the number of off-system transactions needed for operational reasons but mitigate price volatility to end use customers by protecting a substantial portion of Respondent's purchases from daily price fluctuations.

Q. You stated that the baseload quantities reflect similar purchases from prior years. Please explain.

A. Respondent's gas purchasing practices have always included a mix of baseload and swing supplies. The relative amounts of these purchases may change from one year to the next as contracts expire and are replaced with new ones negotiated under different conditions or as other factors affect purchase decisions. Exhibit 5 compares the baseload purchases in the year prior to the GPAA with the baseload quantities in the GPAA for this reconciliation period.

Exhibit 5 is notable for two reasons. First, it demonstrates that the baseload quantities in the GPAA are not unreasonably high. Second, it highlights the fact that the GPAA allowed Respondent to shape the baseload quantities by month. In years prior to the GPAA, Respondent would typically be limited mostly to purchasing baseload quantities either on an annual basis or for the five-month November through March period.

Q. What was the purpose of the SIQ and how was it determined?

A. The SIQ quantities and the months in which they are delivered were determined such that these volumes would be used for storage refill. The range of SIQ deliveries from April through November is from a minimum of xxxxxxxxxxxx MMBtu (xxxxxxxxXXXXxxx for each month in the summer period) to a maximum of xxxxxxxxxxxx MMBtu (xxxxxxxxXXXXxxx for each month in the summer period).

On average, Respondent expected to receive an amount near the midpoint of that range or approximately xxxxxxxxxxxxXXXXxx per year. These purchases would then be used by Respondent to fill its on-system and purchased storage.

Q. What was the purpose of the DIQ and how was it determined?

A. As I discussed above, Respondent's gas supply portfolio has historically included a mix of baseload and swing quantities. The DIQ reflects the swing quantities available to Respondent under the GPAA. For example, if baseload plus SIQ quantities were insufficient to fill storage in the summer or meet requirements, Respondent could nominate a portion of the DIQ. Likewise, on any day that the baseload quantities were insufficient to meet winter demand, the DIQ was available for nomination by Respondent. Respondent would make this

310 nomination as late as two and one-quarter hours prior to the pipeline nomination
311 deadline.

312 Q. Why were the various quantity provisions in the GPAA appropriate?

313 A. The three categories of contract quantities, considered together, provided
314 Respondent with an amount and mix of services comparable to what it previously
315 sought to achieve in several contracts. As discussed above, the GPAA gave
316 Respondent a level of daily purchases that was likely to meet at least minimum
317 requirements with no daily price fluctuations. It also ensured that, on a day-to-
318 day basis, Respondent could purchase a quantity of supply that was equal to the
319 amount of capacity it had released to ENA. In other words, the amount of supply
320 available to Respondent was not diminished by the GPAA or the capacity
321 releases. Finally, there were purchases that could be used to fill purchased and
322 company-owned storage during the non-winter months.

323 Q. Given these different contract provisions governing quantity, how was
324 pricing determined under the GPAA?

325 A. Appropriately, there was not a single price or pricing mechanism
326 applicable to all purchases. When Respondent had multiple contracts for
327 different services, the particular service in each contract was associated with a
328 specific pricing structure. The price applicable to a given purchase under the
329 GPAA was determined by the category (baseload, SIQ and DIQ) into which the
330 gas fell, and the GPAA also provides that the parties may agree to alternative
331 pricing.

332 Q. What price applied to the baseload quantity?

333 A. Absent agreement to a different pricing mechanism, the price applicable to
334 the baseload quantity was

335 [REDACTED]
336 [REDACTED]
337 [REDACTED]
338 [REDACTED]
339 [REDACTED]
340 [REDACTED]

341 Q. What price applied to the SIQ?

342 A. Absent agreement to a different pricing mechanism, the price applicable to
343 the SIQ was the same as applicable to baseload quantity.

344 [REDACTED]
345 [REDACTED].

346 Q. What did the [REDACTED] applicable to the baseload and SIQ translate to in
347 savings during the reconciliation period?

348 A. The [REDACTED] produced savings to customers during the reconciliation
349 period of

350 \$[REDACTED]
351 [REDACTED]
352 [REDACTED].

353 Q. What price applied to the DIQ?

354 A. Absent agreement to a different pricing mechanism, the price applicable to
355 the DIQ was the

[illegible]

365 Q. In contracts that Respondent had in place prior to the GPAA, did
366 Respondent pay a demand charge for swing service?

367 A. Yes, many swing contracts included a demand charge. In recent years,
368 the charges ranged from xxxxxxxxxxxxxxxxxxxxxxxxxx of daily contract
369 quantity. Had the GPAA included such a charge, applying roughly the midpoint
370 of this range, or xxxxxxxxxxxxxxxxxx, to the DIQ available in the reconciliation
371 year, such a charge would have added approximately xxxxxxxx in gas costs.

372 Q. What is the difference between a “first of month” price and a “daily price.”

373 A. As the name suggests, the first of month price is driven by market trading
374 activity in the period leading up to the month. The first of month price, once set,
375 does not change during the month. A first of month price is often used for
376 baseload purchases because the purchase and sale obligation will not vary
377 during the month.

378 XXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXX XXXX XXXXXXXXXXXXXXX

379 XXXXXXXXXX XXXXXXX XXX

380 XX.

381 Similarly, as the name suggests, the daily price is based on day-to-day
382 trading as reflected in publications that publish prices every business day.

383 XXXXXXXXXX XXX

384 XXX

385 XXXXXXXXXXXXXXX A daily price is often used for swing purchases because the
386 purchase and sale obligations are generally not established until the day pipeline
387 nominations for service are made.

388 XXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXX.

389 Q. Why is it reasonable to use Natural Gas Intelligence Weekly Gas Price
390 Index to establish a first of month price?

391 A. Natural Gas Intelligence Weekly Gas Price Index ("NGI") is a readily
392 available, widely used source for setting a market price in gas contracts. Another
393 commonly used publication for first-of-month pricing is Inside F.E.R.C.'s Gas
394 Market Report. Over the years, Respondent has used both of these publications.
395 During the reconciliation period, the pricing in the two publications was
396 comparable. Exhibit 6 compares the first of month prices for the two publications
397 and the difference never exceeded \$0.02.

398 Q. Why is it reasonable to use Gas Daily to establish daily prices?

399 A. Like NGI, Gas Daily is a readily available, widely used source for setting a
400 market price in gas contracts. It is Respondent's experience that Gas Daily is the

most commonly used index for purposes of daily priced contracts, and

Respondent has used it extensively over the years.

Q. How do NGI and Gas Daily establish the prices they publish?

A. Both NGI and Gas Daily rely on the results of confidential surveys of natural gas industry participants to obtain quotes on natural gas prices. A complete discussion of each publishers' pricing methodology is provided in Exhibit 7 along with that for the publisher (Platts) of Inside F.E.R.C.'s Gas Market Report. The publishers each assert that they base the prices on information gathered from scores, often hundreds, of respondents. Also, each publisher describes how it handles a price submitted to it that deviates significantly from the range of other reported prices to avoid what one publisher calls "outliers" from skewing the results.

Q. You stated that Respondent has used these indices in prior years. Please be more specific.

A. In fiscal 1999, the year before the GPAA took effect, Respondent had contracts using each of the publications described above and a mix of first of month and daily pricing with a few contracts based on weekly pricing. Specifically, the contracts had the following pricing mechanisms:

XXXXXXXXXXXXXXXXXXXXXxxxxxxXxXxXxXxxxxXxxxXXXXXXXXXXXXXXXXXXXXXXXXXXXX
XX
XXxxxXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXX.

b. Flexible Pricing Terms

424 Q. You stated that a second criterion that Respondent expected the GPAA to
425 meet was flexible pricing terms. Please describe any pricing agreements during
426 the period that varied from the pricing structure that you just described.

429 xxxxxxxxxxxxxxxxxxxxxxxx, the fixed price would apply to the purchase of these

430 quantities and

[illegible]

434 Q. Why did Respondent agree to these alternative prices?

447 Q. What is the xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx under the GPAA?

[illegible][illegible]

453 XXXX.

456 A. No. Respondent provided no incentives or compensation to ENA, and we
457 do not know why ENA elected not to use the baseload price adjustment.

458 Q. What was the benefit of this provision to Respondent?

[illegible][illegible]

466 **c. Preserving the Value of Transportation Assets**

470 A. As I mentioned, the concern about declining basis is that the value of
471 transportation used to move gas from the field to the citygate will be less than the
472 fixed costs reflected in the firm transportation contracts. In other words, buying
473 gas at the citygate, with the value of transportation embedded in the commodity
474 price, may be less than buying gas in the field and paying to transport the gas to
475 the citygate. Accordingly, buying gas at the citygate would mitigate the risk of
476 declining basis. Buying gas at the citygate meant that some of Respondent's
477 firm transportation was no longer needed to support its supply purchases, so this
478 transportation was released to ENA using the capacity release procedure
479 prescribed by the FERC.

480 Q. At what price was the capacity released?

481 A. The release price was the price stated in Respondent's contract with the
482 pipeline. As prescribed by the FERC's rules, ENA entered into a replacement
483 shipper contract with the pipelines, Respondent's contract remained in effect and
484 the pipelines' bills to Respondent reflected a credit each month for the amount
485 that ENA agreed to pay, *i.e.*, a credit in an amount equal to the price that
486 Respondent was under contract with the pipelines. I also note that the
487 transactions were done as pre-arranged deals,

488 xxxxxxxxxxXX

489 xxxxxxxxxx and the capacity was released with recall rights.

490 These conditions ensured that there was no risk that Respondent would lose its
491 transportation capacity should it ever need the capacity back to meet its
492 requirements.

Q. You stated that Respondent retained control of its purchased and company-owned storage and that it did not release all its transportation capacity to ENA. How was Respondent's retention of these assets coordinated with the GPAA?

A. The GPAA was not a full requirements contract, nor did ENA have any management rights or responsibilities associated with storage. As I stated above, Respondent bought approximately xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx from ENA. Accordingly, it still needed to purchase gas to meet about xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx, and some of these purchases were in the field. That is, they were delivered to the market area through the use of transportation retained by Respondent or the purchases were injected into storage at field locations and later withdrawn and transported to the market area.

Q. How was gas purchased outside of the GPAA priced?

A. Gas purchased outside of the GPAA can be priced any of several ways. Gas purchased under term agreements would generally use one of the commonly available price indices as its default pricing. Gas purchased on the spot market would often be priced at a relevant daily index price or at a negotiated cash price.

d. Flexibility to Meet Requirements

Q. You stated that a fourth objective in negotiating the GPAA was providing a level of flexibility to meet requirements under various market conditions. How does the GPAA satisfy this objective?

A. The first way in which this flexibility was achieved was through the negotiation of the baseload, SIQ and DIQ quantities. Second, Respondent required that the GPAA

XX

XX

xxXX

XX

xxxxxxx. By establishing a contractual right to resell gas to ENA, Respondent substantially eliminated the uncertainty associated with finding a market for excess gas, often on short notice, when operational conditions required it to alleviate an oversupply situation.

The ability to market gas in an oversupply situation is limited and the maximum volume and the pricing tiers were agreed to in order to meet Respondent's desire for a firm standard offer. The conditions that cause Respondent to use the sellback right are characterized by oversupply at its citygate, and it is very possible that the Chicago market, in general, is experiencing an oversupply on days when Respondent would want to use the sellback right. This was a key factor in negotiating the pricing terms.

Q. What are the pricing terms?

A.

XX

XX. This recognizes the oversupplied market conditions that generally accompany a sellback situation

and the relatively short notice that Respondent gives ENA to dispose of the sellback gas. Disposing of up to xxxxxxxxXXXXxx of gas or moving that amount of gas to an alternate market on a day in an oversupplied market is a formidable task. The GPAA transfers that burden from Respondent to ENA.

561 service under the GPAA, which is firm, Respondent could not rely on the park
562 and loan services to alleviate oversupply situations. Also, unlike the sellback,
563 under a park and loan Respondent would eventually need to take delivery of the
564 gas it had parked. There is no assurance that the days for which redeliveries
565 (loan) are scheduled would be days that Respondent needed gas.

566 Finally, as discussed below, the costs associated with pipeline overruns
567 are substantial.

568 Q. Why were the sellback provisions important to Respondent?

569 A. Respondent's requirements are substantially affected by variables over
570 which it has little or no control, namely weather, customer usage and
571 transportation customers' deliveries. Weather, of course, has a major impact on
572 Respondent's sendout in the non-summer months, and even small variations
573 from forecast weather can produce significant sendout changes. Similarly, while
574 Respondent uses its forecasts of customer usage for planning purposes, usage
575 that deviates from the forecast for non-weather related reasons must be
576 accommodated. With respect to transportation customer deliveries, about 40%
577 of Respondent's annual throughput is for such customers, but their daily
578 deliveries show considerable variability. A review of four recent years of data
579 reveals that the daily deliveries from large volume customers have ranged from a
580 low of 20% of system sendout to a high of 124% of system sendout.
581 Respondent's Choices For You[®] transportation program gives Respondent some
582 control over deliveries, but the bulk of transportation deliveries are under
583 programs under which customers have more flexibility.

584 While Respondent purchases assets, such as no-notice storage services,
585 that help it to manage these variables, there are inevitably days when moving
586 gas away from the citygate is the only way to avoid an oversupply situation. This
587 is not a recent phenomenon or unique to the GPAA. What is different about the
588 GPAA is that it includes a specific process for managing oversupply situations
589 that guarantees a market for gas.

590 Q. What are the ramifications of an oversupply situation?

591 A. There are two. One is operational and the second is economic. First, an
592 oversupply must be managed from a safety perspective so that overpressure
593 situations on Respondent's system do not result. Second, an oversupply
594 situation – more gas than Respondent can use to meet requirements and more
595 gas than it can handle through storage activity – would cause pipeline
596 imbalances. For example, Respondent's no-notice storage contracts provide a
597 defined level of no-notice swing down rights. If these rights are exceeded, then
598 penalties apply. Pipeline imbalance penalties can be substantial, depending on
599 the circumstances under which the imbalance occurs. As one example, the
600 unauthorized overrun charge under Natural Gas Pipeline Company of America's
601 tariff is \$10 per dth and there are tiered imbalance charges, increasing with the
602 amount of the imbalance, based on commodity prices. On the other hand, no-
603 notice services are costly and carry fixed charges that are payable irrespective of
604 whether the service is used. Accordingly, it is more cost-effective to use off-
605 system sales as a means of addressing some oversupply situations.

606 **e. Proxy for Prior Years**

607 Q. Finally, you identified the fifth objective of the GPAA negotiations as
608 achieving a contract that was a reasonable proxy for pricing that Respondent
609 achieved in prior years. Did the GPAA satisfy that objective?

610 A. Yes. The commercial terms and conditions of the GPAA are comparable
611 to contracts that Respondent held in prior years. As described above, the
612 quantity provisions (a mix of baseload and swing) and index based pricing are no
613 different than the contracting approach used in prior years. Index based pricing
614 is inherently an approach that yields a market responsive result for customers.
615 The GPAA is simply a single contract for a larger total quantity. Moreover, the
616 sellback provision is a benefit that was often not included in prior year's
617 contracts. In the face of declining basis, the xxxxxxxxxx assured Respondent's
618 customers that they would receive the value of the transportation that was
619 contracted for to meet their firm requirements.

620 Also, Exhibit 8 shows that the GPAA was a reasonable proxy.
621 Specifically Exhibit 8 compares Respondent's actual monthly gas costs for the
622 two fiscal years prior to the GPAA (1998 and 1999), to the same monthly gas
623 purchase volumes priced using the city-gate indices used in the GPAA. It should
624 be noted that this analysis does not reflect the application of the xxxxxxxxxx on
625 baseload and SIQ volumes that Respondent receives as part of the GPAA. Still,
626 the results show that, for the two-year period covering fiscal 1998 and fiscal
627 1999, Respondent's actual total purchases of gas cost

[illegible][illegible]

630 xxxxxxxxxxxxxxxxxxxx. In other words, the costs in the two years prior to the GPAA
631 could be viewed as a Chicago citygate delivered contract with an xxxxxxxxxxxx
632 per MMBtu overall price when using the same pricing indices referenced in the
633 GPAA. Respondent did not consider such an analysis to be the definitive way to
634 assess the GPAA because changing market conditions dictated a more forward
635 looking approach to negotiations. Nonetheless, this exhibit corroborates that the
636 GPAA met Respondent's fifth criterion in negotiating the GPAA.

637 **3. Prudence of the GPAA**

638 Q. Were the gas costs incurred pursuant to the GPAA during the
639 reconciliation period prudent?

640 A. Yes, for several reasons. First, I note that Respondent incurred gas costs
641 under the same agreement during fiscal 2000, and the Commission found those
642 costs to be prudently incurred. Second, the GPAA was a single contract that
643 substituted for multiple contracts with comparable pricing and quantity
644 requirements that Respondent had entered into in years prior to fiscal 2000. The
645 Commission has found these types of contracts to be prudent. Third, the
646 xxxxxxxx produced savings of \$ xxxxxxxx by preserving the value of Respondent's
647 transportation credits. Fourth, the GPAA met each of the five objectives outlined
648 above, each of which I believe is an important element of a gas supply
649 agreement. Those objectives cover both key operational protections necessary
650 for Respondent to provide safe and reliable service to its customers while also
651 providing market-based pricing with the opportunity to vary the stated pricing
652 formulas to achieve some level of price stability.

653 **Off-System Transactions**

654 Q. You stated that Staff asked several data requests related to off-system
655 transactions. Please explain what an "off-system transaction" is and why
656 Respondent enters into these transactions.

657 A. An off-system transaction is a sale of gas or release of capacity or certain
658 exchanges by Respondent. Such transactions are subject to the FERC's
659 jurisdiction. Off-system transactions are an essential operational tool, and some
660 such transactions also offer a vehicle for reducing gas costs. Peoples Gas
661 evaluates all off-system transactions based on the following criteria. The
662 transaction must accomplish one or more of the following: (1) provide a positive
663 commodity credit, (2) provide a positive demand credit, (3) serve to meet an
664 operational need, or (4) serve the purposes of testing the logistics and/or
665 feasibility of future transactions that would meet one of the first three criteria.

666 Q. Did all of the transactions during the reconciliation period meet one or
667 more of the four criteria you described?

668 A. Yes. The majority were to optimize the value of gas supply assets (over
669 one-third of all transactions) or for operational reasons (approximately one-third
670 of all transactions).

671 Q. How do off-system transactions reduce gas costs?

672 A. When an off-system transaction uses assets for which any costs are
673 recovered through the gas charge, the revenues resulting from that transaction
674 are flowed through the gas charge. I am advised by counsel that this is based on
675 the Commission's rules and Respondent's Rider 2, which provide that gas costs

are offset by revenues from transactions that are not subject to the gas charge if any of the costs associated with the transaction are recoverable gas costs. For example, assume that Respondent had an obligation to purchase 1,000 MMBtu of gas at \$3.00 per MMBtu, but conditions were such that it did not need that gas and was able to sell it for \$3.10 per MMBtu. The purchase of gas is a recoverable gas cost (\$3,000) and would be flowed through the gas charge as a cost of gas, and this requires that the revenues (\$3,100) from the sale would also be flowed through the gas charge as a credit.

Q. Did Peoples Gas enter into off-system transactions under the GPAA?

A. Yes. As I have described above, there were capacity releases under the GPAA and there were sales of gas to ENA.

Q. During the reconciliation period, did Peoples Gas enter into off-system transactions with parties other than EMW and ENA?

A. Yes, it had transactions with nine other counterparties, including the use of an electronic trading platform (Altrade, formerly known as QuickTrade). It also released capacity to one counterparty other than ENA.

Q. Did Peoples Gas enter into off-system transactions prior to the GPAA?

A. Yes, it has entered into such transactions every year since such transactions became possible with the issuance of FERC Order No. 547 in November 1992. Order No. 547 permits sales for resale at negotiated rates. Each year in its reconciliation proceeding, Respondent described the type and amount of transactions accounted for in the gas charge.

698 Q. Are the number of off-system transactions in the reconciliation period
699 typical for Respondent?

700 A. There is no typical number of such transactions. In fiscal 2001,
701 Respondent entered into 102 off-system transactions. As I discussed above,
702 there are four criteria that Respondent considers in determining whether to enter
703 into an off-system transaction. Operational considerations and the opportunity to
704 optimize the value of assets that Respondent holds are important factors, and the
705 conditions affecting these factors vary from year-to-year. Respondent had 346,
706 358 and 114 such transactions in fiscal years 1998, 1999, and 2000,
707 respectively.

708 Q. Why did the number of off-system transactions decline after Respondent
709 entered into the GPAA?

710 A. As I have explained, under the GPAA, Respondent released certain
711 transportation assets to ENA. Many of the off-system transactions in previous
712 years had been tied to the use of these assets. Therefore, once the GPAA went
713 into effect, the number of these types of transactions naturally decreased.
714 However, as I also discussed above, the value that Respondent expected to
715 garner from such sales was expected to diminish in the face of declining basis.
716 Also, the sellback provision in the GPAA allowed Respondent to look to a single
717 source to make off-system sales of up to XXXxx per day when operational
718 conditions required such sales. In the past, sales of smaller quantities to several
719 parties, *i.e.*, more operational off-system transactions, may have been required.

720 Q. Are there other types of gas service transactions that Respondent enters
721 into?

722 A. Yes. Respondent uses its system to provide interstate services to
723 customers. These are actually "on-system" transactions in the sense that the
724 service that Respondent provides is entirely supported by assets that it owns and
725 operates.

726 Q. Are the costs and revenues associated with these "on-system
727 transactions" flowed through the gas charge?

728 A. No. As I discussed above, the key factor in determining whether revenues
729 are flowed through the gas charge is whether the transaction uses assets having
730 costs that are flowed through the gas charge.

731 Q. Please describe the types of transactions for which the costs and
732 revenues would not be flowed through the gas charge.

733 A. A good example of such a transaction is the services that Respondent
734 provides pursuant to its Operating Statement on file with the FERC. Peoples
735 Gas received its certificate to offer certain interstate services in 1998. The
736 Operating Statement allows Respondent to provide transportation, storage and
737 parking services using the assets for which the costs are recovered through base
738 rates. Respondent can perform other interstate services that are solely
739 supported through these base rate assets, principally exchange services. In
740 other words, the services use Respondent's transmission and distribution system
741 and its storage field. The revenues from these transactions are not flowed

742 through the gas charge because none of the costs supporting the transaction are
743 recovered through the gas charge.

744 Q. Please give specific examples of these transactions.

745 A. As one example, a shipper could request that Respondent provide a park
746 and loan service pursuant to the FERC Operating Statement. If Respondent
747 determines that it can meet the shipper's request through company-owned
748 assets, it enters into an agreement with the shipper. The shipper would deliver
749 gas to Respondent's system on an agreed upon schedule, subject to interruption
750 by Respondent in accordance with the Operating Statement. This is the "park"
751 element of the service. Respondent would then have an obligation to return a
752 like quantity of gas to the shipper at a point on Respondent's system, *i.e.*, not
753 using any pipeline transportation services, on an agreed upon schedule, subject
754 to interruption by Respondent in accordance with the Operating Statement. This
755 is the "loan" element of the service. The service could also be structured such
756 that the loan occurs before the park. Respondent supports this type of service
757 through its storage field. The costs of the storage field are recovered through
758 base rates. No purchases and sales of gas occur in connection with this
759 transaction, nor does Respondent use any purchased storage or transportation
760 services in support of the transaction. Revenues from these park and loan
761 transactions are recorded by Respondent above the line but not flowed through
762 the gas charge because no recoverable gas costs are associated with the
763 transaction.

764 A second typical example would be an exchange service. An exchange is
765 the same as a park and loan agreement in terms of the physical assets that
766 Respondent uses to support the transaction. Under an exchange, a shipper
767 delivers gas to Respondent under agreed upon terms and conditions, and
768 Respondent commits to redeliver a like quantity of gas to the shipper at some
769 later dates. The receipt of gas occurs at a point on Respondent's transmission
770 and distribution system, and the redelivery also occurs at such a point. In other
771 words, Respondent does not need to use pipeline services to accept or receive
772 the gas, nor does Respondent need to purchase or sell gas to perform the
773 service. The gas that is exchanged is valued at zero cost, as no purchase and
774 sale actually occurs. I am advised by counsel that the authority for these
775 transactions is FERC Order No. 547. Again, Respondent supports this type of
776 service through its storage field, the costs of which are recovered through base
777 rates.

778 Q. How are the revenues from these transactions accounted for?

779 A. Because costs are accounted for above the line, Peoples Gas accounts
780 for these revenues above the line. In other words, in a rate case, the revenues
781 would be taken into consideration in setting base rates just as the costs of the
782 assets used to support the transactions would be taken into consideration.

783 Q. Mr. de Lara discusses an off-system transaction with EMW. He describes
784 errors related in the handling of this transaction. After discovering the errors
785 related to the EMW transaction, did you review other transactions to determine if
786 they were properly handled through the gas charge?

787 A. Yes, Respondent reviewed all 102 transactions that took place during the
788 reconciliation period and that were flowed through the gas charge. Respondent
789 also reviewed all other interstate gas service transactions during the period. The
790 EMW transaction (in certain data responses, it was labeled transactions 16 and
791 22) was the only call option service. It was the only transaction for which costs
792 and revenues were not properly reflected in the gas charge.

793 Q Do you believe that Respondent had adequate processes in place to
794 minimize the possibility of similar errors from occurring?

795 A. Yes. Respondent has a Gas Management System ("GMS") in which
796 various off-system activities are recorded. Gas Supply Administration personnel
797 provide detailed information for each transaction entered into by Respondent.
798 Respondent's Gas Accounting department receives a report from GMS that
799 provides the detailed information. Gas Accounting uses the information to
800 reconcile the volumes and prices to the invoices. If an invoice is not paid in full,
801 any discrepancy will be investigated for accuracy using all documents to
802 reconcile with the information which is in GMS.

803 GMS is the primary tool for ensuring that all gas supply transactions are
804 properly documented and recorded. All traders have received both off-site
805 classroom training and in-house instruction on how to use GMS. Gas supply
806 transaction information is entered into GMS by Peoples Gas' traders. This
807 information would include volume, location, and commodity prices as well as any
808 other costs associated with the transactions. The system also provides for notes
809 and comments to be entered about each transaction. All deal information

810 automatically flows to the "Accounting Module" of GMS. Traders do not have
811 access to the Accounting Module and once deals have flowed to the Accounting
812 Module, they cannot be changed by the traders. A transaction such as the EMW
813 transaction would be described on the deal ticket as a call option service and any
814 fixed charge associated with such a transaction would be entered as a
815 reservation charge on the deal ticket.

816 Q. Given the problems with the EMW transaction, has Respondent taken
817 additional steps to minimize the possibility of such errors?

818 A. Yes. In the case of the EMW transaction, the appropriate GMS entries
819 were not made. In response to this error, Respondent has updated its deal
820 capture procedures and reviewed with its gas supply traders how to record the
821 necessary information in GMS. Each sale transaction record will describe the
822 business purpose of the transaction and identify any individuals, other than the
823 trader entering this data, who may have had involvement in negotiating the
824 transactions. Furthermore, Respondent has installed a voice recording system
825 on certain of its telephone lines and has instructed traders on the technical and
826 legal aspects of recording phone conversations.

827 Q. Who decides what off-system transactions Respondent enters into?

828 A. Peoples Gas' Gas Supply Administration department is responsible for all
829 off-system transactions. The day-to-day deals fall under my supervision and
830 direction.

831 Q. Does anyone other than Peoples Gas personnel have authority to enter
832 into an off-system transaction?

833 A. No.

834 Q. Did Respondent enter into any off-system transaction with an affiliate
835 during the reconciliation period?

836 A. No.

837 Q. Did Respondent sell any gas supply services to an affiliate during the
838 reconciliation period?

839 A. Yes. Respondent sold FERC services to enovate during the reconciliation
840 period. I am advised by counsel that such transactions do not require
841 Commission approval. Respondent also provided a storage service to North
842 Shore Gas Company pursuant to an agreement approved by the Commission.

843 Q. Did Respondent purchase any gas supply services from an affiliate during
844 the reconciliation period?

845 A. Yes. Peoples Gas purchased a peaking service from Peoples Energy
846 Resources Corp. during the period. This service is provided pursuant to an
847 agreement that the Commission approved. Peoples Gas did not purchase any
848 other gas supply services from an affiliate during the reconciliation period.

849 Q. Did Respondent enter into any off-system transaction during the
850 reconciliation period that was intended to benefit an affiliate?

851 A. No. All off-system transactions during the reconciliation period were done
852 only for one of the four purposes I listed earlier in my testimony, and none were
853 done with the intent to benefit any affiliated entity.

854 Q. Did Respondent enter into any off-system transaction during the
855 reconciliation period that was contingent upon the counterparty doing business
856 with an affiliate of Respondent?

857 A. No, Respondent did not sell gas to any party contingent upon that
858 counterparty doing business with an affiliate of Respondent. All gas transactions
859 by Respondent are evaluated solely on the merits of how well the transaction
860 meets one or more of the four stated gas supply purposes.

861 Q. Does this conclude your additional direct testimony?

862 A. Yes, it does.